



STATE OF CALIFORNIA

STATE BOARD OF EQUALIZATION

450 N STREET, SACRAMENTO, CALIFORNIA
PO BOX 942879, SACRAMENTO, CALIFORNIA 94279-0092
1-916-324-1825 • FAX 1-916-322-4530
www.boe.ca.gov

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State Controller

CYNTHIA BRIDGES
Executive Director

March 29, 2013

Dear Interested Party:

Enclosed is the Second Discussion Paper on Regulation 1502, *Computers, Programs, and Data Processing*, with respect to backup copies and charges for “site licenses” to use prewritten software programs. Discussion regarding proposed amendments to Regulation 1502 is scheduled for the Board’s **August 13, 2013 Business Taxes Committee** meeting.

However, before the issue is presented at the Business Taxes Committee meeting, staff would like to provide interested parties an opportunity to discuss “site licenses” and present any suggestions or comments. Accordingly, a meeting is scheduled in **Room 121 at 10:00 a.m. on April 10, 2013**, at the Board of Equalization, 450 N Street, Sacramento, California.

If you are unable to attend the meeting but would like to provide input for discussion, please send your submission to the above address or send a fax to 1-916-322-4530 before the April 10, 2013 meeting. Please feel free to publish this information on your website or otherwise distribute it to your associates, members, or other persons that may be interested in attending the meeting or presenting their comments.

If you plan to attend the meeting on April 10, 2013, or would like to participate via teleconference, please let staff know by contacting Mr. Robert Wilke at 1-916-445-2137 or Robert.Wilke@boe.ca.gov prior to April 8, 2013. This will allow staff to make alternative room arrangements, if necessary, and to arrange for teleconferencing.

Whether or not you are able to attend the above interested parties’ meeting, please keep in mind that the due date for interested parties to provide written responses to staff’s analysis is **April 25, 2013**. Please be aware that a copy of the material you submit may be provided to other interested parties. Therefore, ensure your comments do not contain confidential information.

If you are interested in other topics to be considered by the Business Taxes Committee, you may refer to the “Business Taxes Committee” page on the Board’s Internet web site (<http://www.boe.ca.gov/meetings/btcommittee.htm>) for copies of Committee discussion or issue papers, minutes, a procedures manual and calendars arranged according to subject matter and by month.

Thank you for your consideration. I look forward to your comments and suggestions. Should you have any questions, please feel free to contact Ms. Kirsten Stark, Supervisor, Business Taxes Committee Team and Training Section, at 1-916-322-0849.

Sincerely,



Susanne Buehler, Chief
Tax Policy Division
Sales and Use Tax Department

SB:rsw

Enclosures

cc: (all with enclosures)

Honorable Jerome E. Horton, Chairman, Fourth District
Honorable Michelle Steel, Vice Chair, Third District
Honorable Betty T. Yee, Member, First District (MIC:71)
Senator George Runner (Ret.), Member, Second District (via email)
Honorable John Chiang, State Controller, c/o Ms. Marcy Jo Mandel

(via email)

Mr. David Hunter, Board Member's Office, Fourth District
Mr. Neil Shah, Board Member's Office, Third District
Mr. Tim Treichelt, Board Member's Office, Third District
Mr. Alan LoFaso, Board Member's Office, First District
Ms. Mengjun He, Board Member's Office, First District
Mr. Sean Wallentine, Board Member's Office, Second District
Mr. James Kuhl, Board Member's Office, Second District
Mr. Lee Williams, Board Member's Office, Second District
Mr. Alan Giorgi, Board Member's Office, Second District
Ms. Lynne Kinst, Board Member's Office, Second District
Ms. Natasha Ralston Ratcliff, State Controller's Office
Ms. Cynthia Bridges (MIC:73)
Mr. Randy Ferris (MIC:83)
Mr. Jeffrey L. McGuire (MIC:43)
Mr. Jeff Vest (MIC:85)
Mr. David Levine (MIC:85)
Ms. Robert Tucker (MIC:82)
Mr. Bradley Heller (MIC:82)
Mr. Todd Gilman (MIC:70)
Ms. Laureen Simpson (MIC:70)
Mr. Bill Benson (MIC:67)
Mr. Joe Fitz (MIC:67)

Mr. Wayne Mashihara (MIC:46)
Mr. Kevin Hanks (MIC:49)
Mr. Bradley Miller (MIC:92)
Ms. Kirsten Stark (MIC:50)
Mr. Robert Wilke (MIC:50)

SECOND DISCUSSION PAPER

Regulation 1502, *Computers, Programs, and Data Processing*

Issues

1. Whether the Board should amend Regulation 1502, *Computers, Programs, and Data Processing*, to expressly clarify that when a consumer purchases a non-custom computer program (hereafter prewritten software) via an electronic download or load-and-leave transaction that does not include the transfer of tangible storage media, and also purchases a separate optional software maintenance contract that includes the transfer of a backup copy of the same or similar prewritten software recorded on tangible storage media, then tax does not apply to the charge for the prewritten software itself, and tax applies to 50 percent of the lump-sum charge for the optional software maintenance contract.
2. Whether the Board should amend Regulation 1502 to clarify whether and to what extent charges for “site licenses” to use prewritten software recorded on tangible storage media should be excluded from the measure of tax.

Background Regarding Issue 1 Pertaining to Backup Copies

During the January 15, 2013, Business Taxes Committee (BTC) meeting regarding the issue of whether to amend Regulation 1502, and/or amend Regulation 1507, *Technology Transfer Agreements*, the Board authorized staff to conduct additional, focused interested parties meetings on issues which, based on prior interested parties meetings, have the best potential for immediate resolution. One of those issues is potential amendments to Regulation 1502 to expressly clarify that when a consumer purchases prewritten software via an electronic download or load-and-leave transaction that does not include the transfer of tangible storage media, and also purchases a separate optional software maintenance contract that includes the transfer of a backup copy of the same or similar prewritten software recorded on tangible storage media, then tax does not apply to the charge for the prewritten software itself, and tax applies to 50 percent of the lump-sum charge for the optional software maintenance contract.

Current Regulation 1502

Regulation 1502 prescribes the application of tax to sales of prewritten software and maintenance contracts sold in connection with the sale or lease of prewritten software. Regulation 1502, subdivision (f)(1) explains that prewritten software may be recorded on tangible storage media or coding sheets and provides that tax applies to the sale or lease of storage media or coding sheets on which or into which prewritten software has been recorded, coded, or punched. Regulation 1502, subdivision (f)(1)(D) provides that the sale or lease of prewritten software is not a taxable transaction if the software is “transferred [in an electronic download transaction] by remote telecommunications from the seller’s place of business, to or through the purchaser’s computer and the purchaser does not obtain possession of any tangible personal property, such as storage media, in the transaction.” Subdivision (f)(1)(D) also provides that the sale of prewritten software is not a taxable transaction if the software is “installed by the seller on the customer’s computer [in a load-and-leave transaction] except when the seller transfers title to or possession of storage media or the installation of the program is a part of the sale of the computer.”

The first paragraph in Regulation 1502, subdivision (f)(1)(C), describes the characteristics of

SECOND DISCUSSION PAPER

Regulation 1502, *Computers, Programs, and Data Processing*

software maintenance contracts. It provides that:

Maintenance contracts sold in connection with the sale or lease of prewritten computer programs generally provide that the purchaser will be entitled to receive, during the contract period, storage media on which prewritten program improvements or error corrections have been recorded. The maintenance contract also may provide that the purchaser will be entitled to receive, during the contract period, telephone or on-site consultation services.

Prior to January 1, 2003, all of the charges for optional software maintenance contracts were generally taxable because subdivision (f)(1)(C) provided that “If the purchase of the maintenance contract is optional with the purchaser, but the purchaser does not have the option to purchase the consultation services in addition to the sale or lease of storage media containing program improvements or error corrections, then the charges for the consultation services are taxable as part of the sale or lease of the storage media.” However, in 2002, the Board amended subdivision (f)(1)(C), to read as follows:

For reporting periods commencing on or after January 1, 2003, if the purchase of the maintenance contract is optional with the purchaser, that is, if the purchaser may purchase the prewritten software without also purchasing the maintenance contract, and there is a single lump sum charge for the maintenance contract, 50 percent of the lump sum charge for the maintenance contract is for the sale of tangible personal property and tax applies to that amount; the remaining 50 percent of the lump sum charge is nontaxable charges for repair.

If no tangible personal property whatsoever is transferred to the customer during the period of the maintenance contract, tax does not apply to any portion of the charge. Tax does not apply to a separately stated charge for consultation services if the purchaser is not required to purchase those services in order to purchase or lease any tangible personal property, such as a prewritten computer program or a maintenance contract.

The 2002 amendments recognized that optional software maintenance contracts often involve both the sale or lease of taxable tangible personal property and the provision of nontaxable services and established the bright-line rule that only 50 percent of the lump-sum charge for an optional software maintenance contract is for the sale of taxable tangible personal property.

Need for Clarification Regarding Backup Copies

Board staff understands that some retailers may sell or lease prewritten software via electronic download and/or load-and-leave transactions and also offer to separately sell their customers optional software maintenance contracts that entitle the customers to receive a backup copy of the same or similar prewritten software recorded on tangible storage media, which the customers may use to restore lost or corrupted data. Board staff understands that, in this particular situation, there is some confusion as to:

SECOND DISCUSSION PAPER

Regulation 1502, *Computers, Programs, and Data Processing*

- Whether the charges for the prewritten software that was sold or leased in the electronic download or load-and-leave transaction qualify as nontaxable charges under Regulation 1502, subdivision (f)(1)(D) when customers also purchase such a software maintenance contract and are ultimately entitled to receive a backup copy of the same or similar prewritten software that the customers bought or leased in the electronic download or load-and-leave transaction that is recorded on tangible storage media; and
- Whether such a software maintenance contract can be properly characterized as “optional” so that only 50 percent of the lump-sum charge for the software maintenance contract is taxable under Regulation 1502, subdivision (f)(1)(C).

This is because the first paragraph of Regulation 1502, subdivision (f)(1)(C) specifies that maintenance contracts generally provide that the purchaser is entitled to receive storage media upon which “improvements” and “error corrections” are recorded, and some retailers are not sure whether such a backup copy is included in that reference. In addition, there are no provisions in Regulation 1502, subdivision (f)(1)(C) or (D) that expressly indicate that nontaxable electronic download and load-and-leave transactions may be appropriately paired with optional software maintenance contracts, subject to tax at 50 percent of the lump-sum charge, that entitle customers to receive tangible storage media.

Staff’s Recommendation to Clarify the Treatment of Backup Copies

Staff believes that the 2002 amendments to Regulation 1502, subdivision (f)(1)(C) were intended to create a bright-line rule that only 50 percent of the lump-sum charge for an optional software maintenance contract is taxable. In addition, staff believes that the language in the first paragraph of Regulation 1502, subdivision (f)(1)(C), is intended to generally describe software maintenance contracts, not limit the types of tangible personal property that can be transferred under software maintenance contracts, including optional software maintenance contracts.

Furthermore, staff did not believe that the Board intended for optional software maintenance contracts to be taxed differently merely because they provide that the customer is entitled to receive storage media containing a backup copy of a prewritten program, so that the purchaser may use the backup copy to restore lost or corrupted data from the original prewritten program to which the maintenance contract relates. And, staff did and still does not believe that the current provisions of Regulation 1502 are intended to prohibit the application of subdivision (f)(1)(C)’s provisions to optional software maintenance contracts sold in connection with nontaxable electronic download and load-and-leave transactions described in subdivision (f)(1)(D). Therefore, Board staff proposed amendments to Regulation 1502, subdivision (f)(1)(C) to clarify that software maintenance contracts, including optional maintenance contracts, may include a backup copy of the same or similar prewritten software recorded on tangible storage media, so that the purchaser may use the backup copy to restore lost or corrupted data. Board staff also proposed and still proposes amendments to Regulation 1502, subdivision (f)(1)(D) to clarify that subdivision (f)(1)(C) applies to optional software maintenance contracts sold in connection with nontaxable transactions described in subdivision (f)(1)(D).

SECOND DISCUSSION PAPER

Regulation 1502, *Computers, Programs, and Data Processing*

Interested Parties Comments

Board staff conducted an interested parties meeting to discuss the proposed amendments to Regulation 1502, subdivision (f)(1)(C) and (D) on March 6, 2013. During the meeting, Mark Nebergall expressed his understanding that backup copies of prewritten programs are simply used to restore prewritten programs, rather than lost or corrupted data, as stated in staff's proposed amendments to Regulation 1502, subdivision (f)(1)(C), and recommended that staff's proposed amendments to subdivision (f)(1)(C) be revised accordingly. Mr. Nebergall also expressed his understanding that it is not currently a common business practice for software retailers to provide a backup copy of prewritten software to their customers as part of an optional software maintenance agreement. Staff agreed to consider the requested revision to its proposed amendments and explained that the proposed amendments are intended to eliminate confusion regarding the treatment of backup copies of prewritten programs under existing law and that the clarification may lead to changes in software retailers' current business practices.

Board staff also received written comments from Mr. Nebergall in a letter dated March 22, 2013 (Exhibit 1), which he sent on behalf of the California business community. In the letter, Mr. Nebergall reiterated his comments from the interested parties meeting, and indicated that the business community does not oppose staff's proposed amendments to Regulation 1502, subdivision (f)(1)(C) and (D) with the revision he previously requested. Mr. Nebergall also explained that:

Our concern with the approach set forth in the initial discussion paper is it *may* be at odds with the technology transfer agreement ("TTA") statutes, as construed by the recent decision in *Nortel*. . . . The court in *Nortel* held agreements for the sale of pre-written computer programs are eligible for the TTA exclusion. Our concern with the proposal set forth in the initial discussion paper has to do with cases where the both the underlying software and software maintenance are provided electronically or by load and leave and the backup copy of the underlying software is sold separately. By sold "separately," we mean the backup copy was sold at the same time as the software but appears as a separate item on the invoice or was sold at a later time. In our view, the TTA statutes would require that sales or use tax only be applied to the amount stated on the invoice for the backup copy. . . . [emphasis provided].

Staff agrees with Mr. Nebergall's suggested revision to staff's proposed amendments to Regulation 1502, subdivision (f)(1)(C), and has incorporated the revision into the proposed amendments to Regulation 1502 illustrated in Exhibit 2 to this discussion paper. Staff believes that consideration of the other comments regarding the application of the TTA statutes (Rev. & Tax Code, §§ 6011, subd. (c)(10), and 6012, subd. (c)(10)), and the Court of Appeal's decision in *Nortel Networks, Inc., v. State Board of Equalization* (2011) 191 Cal.App.4th 1259 are beyond the scope of the Regulation 1502-focused interested parties meetings the Board authorized in January 2013. However, the Board may authorize further discussions with interested parties focused on whether it is necessary to amend Regulation 1507, *Technology Transfer Agreements*, to clarify the application of the TTA statutes or *Nortel* when staff reports back to the Board in August 2013.

SECOND DISCUSSION PAPER

Regulation 1502, *Computers, Programs, and Data Processing*

Although the backup copy issue is no longer the focus of the remaining interested parties meetings authorized in January 2013, staff still welcomes any comments and input from interested parties on the backup copy issue. Staff also remains open to informal discussions that might lead to a consensus regarding the application of the TTA statutes to sales of prewritten software recorded on tangible storage media.

Background Regarding Issue 2 Pertaining to Site Licenses

During the January 15, 2013, BTC meeting, the Board also authorized staff to hold additional focused interested parties meetings to try to reach some consensus between industry and staff as to whether and to what extent charges for “site licenses” to use prewritten software recorded on tangible storage media should be excluded from the measure of tax; and if some consensus can be reached, discuss the text of amendments to Regulation 1502 that would further clarify the treatment of charges for “site licenses.”

Current Regulation 1502

Neither the Sales and Use Tax Law nor Regulation 1502 define the term “site license.” Regulation 1502, subdivision (f)(1)(A) and (B) currently provide as follows:

Tax applies to the sale or lease of the storage media or coding sheets on which or into which such prewritten (canned) programs have been recorded, coded, or punched.

(A) Tax applies whether title to the storage media on which the program is recorded, coded, or punched, passes to the customer, or the program is recorded, coded, or punched on storage media furnished by the customer. The temporary transfer of possession of a program, for a consideration, for the purpose of direct use or to be recorded or punched by the customer, or by the lessor on the customer's premises, is a lease of tangible personal property. The tax applies unless the property is leased in substantially the same form as acquired by the lessor and the lessor has paid sales tax reimbursement or use tax with respect to the property.

(B) Tax applies to the entire amount charged to the customer. Where the consideration consists of license fees, all license fees, including site licensing and other end users fees, are includable in the measure of tax. Tax does not apply, however, to license fees or royalty payments that are made for the right to reproduce or copy a program to which a federal copyright attaches in order for the program to be published and distributed for a consideration to third parties, even if a tangible copy of the program is transferred concurrently with the granting of such right. Any storage media used to transmit the program is merely incidental.

The first two sentences in paragraph (B) are intended to explain that tax applies to the entire amount charged to the customer for a prewritten program recorded on tangible storage media, including charges for the increased use of the prewritten program, no matter how the consideration is characterized, and explain that when such consideration is characterized as

SECOND DISCUSSION PAPER

Regulation 1502, *Computers, Programs, and Data Processing*

license fees, then all the license fees, including license fees denoted as “site licenses” are subject to tax. However, the first two sentences in paragraph (B) do not appear to staff to be intended to tax consideration paid for the sale of copyright interests that are truly separate and distinct from the sale of a prewritten program recorded on tangible storage media, as opposed to charges for the increased use of the program, as indicated by the third and fourth sentences in paragraph (B). That paragraph explains that tax does not apply to “license fees or royalty payments that are made for the right to reproduce or copy a program to which a federal copyright attaches in order for the program to be published and distributed for a consideration to third parties, even if a tangible copy of the program is transferred concurrently with the granting of such right.”

Clarification of the “Site License” Issue

The Board’s Legal Department has historically concluded that site license fees which are paid so that a purchaser of a prewritten program recorded on tangible storage media may make additional copies of the program and any other charges that are paid so that the purchaser obtains increased use of the prewritten program represent additional taxable consideration for the sale of the prewritten program, except when the third and fourth sentences of Regulation 1502, subdivision (f)(1)(B) apply. (See Sales and Use Tax Annotations 120.0528 (1/27/86) and 120.0552 (1/6/92).) Board staff has not determined that any amendments to Regulation 1502, subdivision (f)(1)(B) are necessary at this time because the subdivision is consistent with the Legal Department’s historical treatment of site licenses. Therefore, in order to fully address the site license issue, staff is first trying to determine whether there are any other circumstances, which are not already described in Regulation 1502, subdivision (f)(1)(B) where there is a transfer of the right to reproduce or copy a prewritten program to which a federal copyright attaches that is so separate and distinct from the sale of the prewritten program recorded on tangible storage media that the charges for the right to reproduce or copy should be exempt or excluded from tax. If staff determines that other circumstances do exist, then staff will work to clarify Regulation 1502 so that tax continues to apply to the entire amount charged to the customer for a prewritten program recorded on tangible storage media, but does not apply to license fees for the transfer of copyrights that are sufficiently separate and distinct from a prewritten program recorded on tangible storage media.

Terminology

Staff is not entirely sure that the term “site license” necessarily provides the correct nomenclature for this topic. This is because staff’s preliminary research now indicates that the term “site license” generally refers to a license that allows multiple users to use the same program or copies of the same program at one location or site, and the discussion of the “site license” issue may include other licenses that are commonly sold to make and use multiple copies of the same program regardless of the location where the copies are used. Therefore, staff invites input from the interested parties as to whether they believe this issue should include a broader discussion of “license fees” paid for the right to reproduce or copy copyrighted programs recorded on tangible storage media.

Common Practice in the Industry

Board staff only has a limited understanding of the types of licenses that are commonly sold by software retailers and the fees that are commonly charged for such licenses from Board staff’s

SECOND DISCUSSION PAPER

Regulation 1502, *Computers, Programs, and Data Processing*

experience as consumers and representing the agency as a consumer. Therefore, Board staff also invites input regarding the scope of the various types of licenses that software retailers commonly sell in retailer-to-household consumer transactions and retailer-to-business consumer transactions involving the transfer of prewritten software recorded on tangible storage media, and, staff would appreciate any examples industry can provide. Staff believes that a better understanding of the software industry's common practices in this regard, may help lead to a consensus as to whether there are any circumstances, which are not already described in Regulation 1502, subdivision (f)(1)(B) where charges for the right to reproduce or copy a prewritten program recorded on tangible storage media are exempt or excluded from tax.

April Interested Parties Meeting

There is an interested parties meeting scheduled for April 10, 2013, to discuss the "site license" issue. During the meeting, Board staff will be prepared to discuss whatever additional information regarding software licenses that industry provides. Board staff will also be prepared to discuss whether the Board should clarify its treatment of any software licenses. If there appears to be a consensus between industry and staff regarding a need to change the Board's treatment of specific types of software licenses during the interested parties meeting, then staff will begin to discuss specific amendments to Regulation 1502 during the meeting and staff will work on proposing specific amendments to Regulation 1502 to clarify the treatment of those licenses in the third discussion paper, which will be distributed prior to the June 5, 2013, interested parties meeting.

Summary

Staff welcomes any comments, suggestions, and input from interested parties on the "site license" issue. Staff invites interested parties to participate in the April 10, 2013, and June 5, 2013, meetings to discuss the issue of "site licenses" and the deadline for interested parties to provide written responses to this discussion paper is April 25, 2013. Currently, the April and June meetings are the only interested parties meetings scheduled to discuss the "site license" issue before it will be discussed, along with the related backup copy issue, at the August 13, 2013, BTC meeting.

Prepared by the Tax Policy Division, Sales and Use Tax Department

Current as of March 29, 2013



March 22, 2013

Via Email

Susanne Buehler, Chief
Tax Policy Division
Sales and Use Tax Department
State board of Equalization
450 N Street
Sacramento, California

**Re: Initial Discussion Paper on Regulation 1502,
Computers, Programs, and Data Processing**

Dear Ms. Buehler:

This letter is the response of the California business community to your Initial Discussion Paper on Regulation 1502, *Computers, Programs, and Data Processing*. The issue presented in the discussion paper is whether the Board should amend Regulation 1502, Computers, Programs, and Data Processing, to expressly clarify if a consumer purchases a non-custom computer program (hereafter prewritten software) via an electronic download or load-and-leave transaction that does not include the transfer of tangible storage media, and also purchases a separate optional software maintenance contract that includes the transfer of a backup copy of the same or similar prewritten software recorded on tangible storage media, then tax does not apply to the charge for the prewritten software itself, and tax does apply to 50 percent of the lump-sum charge for the optional software maintenance contract. While we have some concerns with the proposal set forth in the initial discussion paper, we generally do not oppose the suggested changes to Regulation 1502.

First, the initial discussion paper is premised on the misunderstanding that delivery of a backup copy of a computer program as part of a separate, optional, software maintenance contract is a common business practice. We believe delivery of a backup copy of a computer program as part of a separate, optional, software maintenance contract is not a common business practice. At the

interested parties meeting held on March 6, 2013, staff agreed that such is not a common business practice. However, if such a practice became common, the proposed revision to Regulation 1502 could provide a mechanism by which those who sell electronically delivered software could reduce their exposure on audit to claims of addition tax where it was discovered the purchaser was in possession of a backup copy of the underlying software. If the backup copy of the software was treated as obtained pursuant to an optional software maintenance contract and not treated as received as part of the purchase of the software, then the seller's exposure to additional sales or use tax would be limited to tax on 50 percent of the price of the maintenance contract instead of tax on 100 percent of the sales price of the underlying software.

Our concern with the approach set forth in the initial discussion paper is it may be at odds with the technology transfer agreement ("TTA") statutes, as construed by the recent decision in *Nortel*. As you know, the TTA statutes provide the term "sales price" does not include

The amount charged for intangible personal property transferred with tangible personal property in any technology transfer agreement, if the technology transfer agreement separately states a reasonable price for the tangible personal property.

The court in *Nortel* held agreements for the sale of pre-written computer programs are eligible for the TTA exclusion. Our concern with the proposal set forth in the initial discussion paper has to do with cases where the both the underlying software and software maintenance are provided electronically or by load and leave and the backup copy of the underlying software is sold separately. By sold "separately," we mean the backup copy was sold at the same time as the software but appears as a separate item on the invoice or was sold at a later time. In our view, the TTA statutes would require that sales or use tax only be applied to the amount stated on the invoice for the backup copy. Treating the backup copy as having been sold in connection with an optional software maintenance contract and thus taxable at 50% of the sales price of the maintenance contract, even though both the software and the maintenance were delivered electronically or by load and leave, would subject to tax a transaction that, under the applicable statutes and regulation, should not be taxable at all.

As we mentioned at the interested parties meeting, we also have a concern with the language of the proposed change to Regulation 1502(f)(1)(C). Backup copies of computer programs generally are used to restore the program for a variety of reason. For instance, the computer on which the program is installed may experience a hardware problem, such as a defective disk drive on which the program is installed, necessitating replacement, which would, in turn, require reloading of the program from the backup copy. Backup copies of computer programs generally are not used to restore lost or corrupted data. We recommend the proposed revision to Regulation 1502(f)(1)(C) be modified as follows:

The maintenance contracts may provide that the purchaser is entitled to receive storage media on which a backup copy of the same or similar prewritten program is recorded, so that the purchaser may use the backup copy to restore ~~lost or corrupted data~~ the prewritten program.

We thank you for the opportunity to provide these comments and we hope you find them useful. If you have any questions or need further information, please contact the undersigned at (202) 486-3725 or mnebergall@softwarefinance.org.

Respectfully submitted,

A handwritten signature in black ink, appearing to read 'Mark E. Nebergall', with a stylized flourish at the end.

Mark E. Nebergall
President
Software Finance & Tax Executives Council
On behalf of the California Business Community

CC: Randy Ferris
Bradley Heller
Robert Wilke

Regulation 1502. *Computers, Programs, and Data Processing.*

Reference: Sections 995.2, 6006, 6007, 6010, 6010.9, 6011, 6012, 6015, and 6016, Revenue and Taxation Code.

(a) In General. “Automatic data processing services” are those rendered in performing all or part of a series of data processing operations through an interacting assembly of procedures, processes, methods, personnel, and computers.

Automatic data processing services may be provided by manufacturers of computers, data processing centers, systems designers, consultants, software companies, etc. In addition, there are banks and other businesses which own or lease computers and use them primarily for their own purposes but occasionally provide services to others. Businesses rendering automatic data processing services will be referred to herein as “data processing firms.”

(b) Definition of Terms.

(1) Application. The specific job performance by an automatic data processing installation. For example, data processing for a payroll may be referred to as a payroll application.

(2) Coding. The list, in computer code, of the successive computer instructions representing successive computer operations for solving a specific problem.

(3) Computer. A computer is an electronic device (including word processing equipment and testing equipment) or combination of components, which is programmable and which includes a processor (central processing unit or microprocessor), internal memory, and input and output connections. Manufacturing equipment which incorporates a computer is a computer for purposes of this regulation. However, the term does not include manufacturing equipment which operates under the control of mechanical or electronic accessories, the attachment to the equipment of which is required for the machine to operate. An electronic device otherwise qualifying as a computer remains a computer even though it may be used for information processing, data acquisition, process control or for the control of manufacturing machinery or equipment.

(4) Custom Computer Program and Programming. A computer program prepared to the special order of the customer. A program prepared to the special order of the customer qualifies as a custom program even though it may incorporate preexisting routines, utilities or similar program components. It includes those services represented by separately stated charges for modifications to an existing prewritten program which are prepared to the special order of the customer.

(5) Data Entry (including Encoding). Recording information in or on storage media by punching the holes or inserting magnetic bits to represent letters, digits, and special characters.

(6) Digital Pre-Press Instruction. The creation of original information in electronic form by combining more than one computer program into specific instructions or information necessary to prepare and link files for electronic transmission for output, within the printing industry, to film, plate, or direct to press, which is then transferred on electronic media such as tape or compact disc.

(7) Input. The information or data transferred, or to be transferred, from storage media into the internal storage of the computer.

(8) Output. The information transferred from the internal storage of the computer to storage media or tabulated listing.

(9) Prewritten Program. A program held or existing for general or repeated sale or lease. The term also includes a program developed for in-house use which is subsequently offered for sale or lease as a product.

(10) Program. “Program” is the complete plan for the solution of a problem, i.e., the complete sequence of automatic data processing equipment instructions necessary to solve a problem, and includes both systems and application programs and subdivisions thereof. “Subdivision” includes, without limitation, assemblers, compilers, generators, procedures, functions, routines, and utility programs. “Problem” means and includes any problem that may be addressed or resolved by a program or subdivision; and the “problem” addressed need not constitute the full array of a purchaser’s or user’s problems, requirements, and desired features. “Problem” further includes, without limitation, any problem associated with: information processing; the manipulation or storage of data; the input or output of data; the transfer of data or programs, including subdivisions; the translation of programs, including subdivisions, into machine code; defining procedures, functions, or routines; executing programs or subdivisions that may be invoked within a program; and the control of equipment, mechanisms, or special purpose hardware.

(11) Proof Listing. A tabulated listing of input.

(12) Source Documents. A document supplied by a customer of a data processing firm from which basic data are extracted (e.g., sales invoice).

(13) Storage Media. Includes hard disks, floppy disks, diskettes, magnetic tape, cards, paper tape, drums and other devices upon which information is recorded.

(c) Basic Applications of Tax.

(1) The transfer of title, for a consideration, of tangible personal property, including property on which or into which information has been recorded or incorporated, is a sale subject to tax.

(2) Charges for producing, fabricating, processing, printing, imprinting or otherwise physically altering, modifying or treating consumer-furnished tangible personal property

(cards, tapes, disks, etc.), including charges for recording or otherwise incorporating information on or into such tangible personal property, are generally subject to tax.

(3) A transfer for a consideration of the title or possession of tangible personal property which has been produced, fabricated, or printed to the special order of the customer, including property on which or into which information has been recorded or incorporated, is generally a sale subject to tax. However, if the contract is for the service of researching and developing original information for a customer, tax does not apply to the charges for the service. The tangible personal property used to transmit the original information is merely incidental to the service.

(4) Charges for the transfer of computer-generated output are subject to tax where the true object of the contract is the output and not the services rendered in producing the output. Examples include artwork, graphics, and designs. However, the transfer by the seller of the original information created by digital pre-press instruction is not subject to tax if the original information is a custom computer program as explained in subdivision (f)(2)(F).

(5) Charges for processing customer-furnished information (sales data, payroll data, etc.) are generally not subject to tax. (For explanation and specific application of tax, see subdivision (d).)

(6) Leases of tangible personal property may be subject to tax under certain conditions. (See Regulation 1660 for application of tax to leases.)

(7) Charges made for the use of a computer, on a time-sharing basis, where access to the computer is by means of remote telecommunication, are not subject to tax (See subdivision (i).)

(8) Generally, data processing firms are consumers of all tangible personal property, including cards and forms, which they use in providing nontaxable services unless a separate charge is made to customers for the materials, in which case tax applies to the charge made for the materials.

(d) Manipulation of Customer-Furnished Information as Sale or Service.

(1) General. Generally tax applies to the conversion of customer-furnished data from one physical form of recordation to another physical form of recordation. However, if the contract is for the service of developing original information from customer-furnished data, tax does not apply to the charges for the service. The tangible personal property used to transmit the original information is merely incidental to the service.

(2) Data Entry and Verification. This covers situations where a data processing firm's agreement provides only for data entry, data verification, and proof listing of data, or any combination of these operations. It does not include contracts under which these services are performed as steps in processing of customer-furnished information as discussed under subdivision (d)(5).

Agreements providing solely for data entry and verification, or data entry providing a proof list and/or verifying of data are regarded as contracts for the fabrication of storage media and sale of proof lists. Charges therefor are taxable, whether the storage media are furnished by the customer or by the data processing firm. Tax also applies to charges for the imprinting of characters on a document to be used as the input medium in an optical character recognition system. The tax application is the same regardless of which type of storage media is used in the operation.

(3) Addressing (Including Labels) for Mailing. Where the data processing firm addresses, through the use of its computer or otherwise, material to be mailed, with names and addresses furnished by the customer or maintained by the data processing firm for the customer, tax does not apply to the charge for addressing. Similarly, where the data processing firm prepares, through the use of its computer or otherwise, labels to be affixed to material to be mailed, with names and addresses furnished by the customer or maintained by the data processing firm for the customer, tax does not apply to the charge for producing the labels, whether or not the data processing firm itself affixes the labels to the material to be mailed. (For the sale of mailing list by the proprietor or such list as a sale of tangible personal property or as a nontaxable addressing, see Regulation 1504 “Mailing-Services.”)

(4) Microfilming and Photorecording. Tax applies to charges for microfilming or photorecording except, as provided in subdivision (d)(5), where the microfilming or photorecording is done under a contract for the processing of customer-furnished information. Tax applies to a contract where data on magnetic tape are converted into combinations of alphanumeric printing, curve plotting and/or line drawings, and put on microfilm or photorecording paper.

(5) Processing of Customer-Furnished Information.

(A) “Processing of customer-furnished information” means the developing of original information from data furnished by the customer. Examples of automatic data processing processes which result in original information are summarizing, computing, extracting, sorting and sequencing. Such processes also include the updating of a continuous file of information maintained by the customer with the data processing firm.

(B) “Processing of customer-furnished information” does not include: (1) an agreement providing solely for the reformatting of data or for the preparation of a proof listing or the performance of an edit routine or other pre-processing, (2) the using of a computer as a mere printing instrument, as in the preparation of personalized computer-printed letters, (3) the mere converting of data from one medium to another, or (4) an agreement under which a person undertakes to prepare artwork, drawings illustrations, or other graphic material unless the provisions of subdivision (f)(2)(F) apply regarding digital pre-press instruction and custom computer programs. Additionally, graphic material furnished incidentally to the performance of a service is not subject to tax. For example, graphics furnished in connection with the performance of architectural, engineering, accounting, or similar professional services are not subject to tax. With respect to

typography, clip art combined with text on the same page is considered composed type as explained in Regulation 1541.

(C) Contracts for the processing of customer-furnished information usually provide that the data processing firm will receive the customer's source documents, record data on storage media, make necessary corrections, process the information, and then record and transfer the output to the customer.

Where a data processing firm enters into a contract for the processing of customer-furnished information, the transfer of the original information to the customer is considered to be the rendering of a service. Except as described in subdivisions (c)(8) and (d)(5)(E), tax does not apply to the charges made under contracts providing for the transfer of the original information whether the original information is transferred on storage media, microfilm, microfiche, photorecording paper, input media for an optical character recognition system, punched cards, preprinted forms, or tabulated listing. The breakdown of the total charge into separate charges for each operation involved in processing the customer-furnished information will not change the application of tax.

(D) The furnishing of computer programs and data by the customer for processing under direction and control of the data processing firm will not alter the application of tax, notwithstanding that charges are based on computer time.

(E) Taxable Items. Where a data processing firm has entered into a contract which is regarded as a service contract under subdivision (d)(5)(C) and the data processing firm, pursuant to the contract, transfers to its customer tangible property other than property containing the original information, such as duplicate copies of storage media: inventory control cards for use by the customer; membership cards for distribution by the customer; labels (other than address labels); microfiche duplicates; or similar items for use, tax applies to the charges made for such items. If no separate charge is made, tax applies to that portion of the charge made by the data processing firm which the cost of the additional computer time (if any), cost of materials, and labor cost to produce the items bear to the total job cost.

(F) Additional Copies. When additional copies of records, reports, tabulation, etc., are provided, tax applies to the charges made for the additional copies. "Additional copies" are all copies (other than carbon copies), whether the copies are prepared by rerunning the same program, by using multiple simultaneous printers, by looping a program such that the program is run continuously, by using different programs to produce the same output product, or by other means. Where additional copies are prepared, the tax will be measured by the charge made by the data processing firm to the customer. If no separate charge is made for the additional copies, tax applies to that portion of the gross receipts which the cost of the additional computer time (if any), the cost of materials and labor cost to produce the additional copies bear to the total job cost. Charges for copies produced by means of photocopying, multilithing, or by other means are subject to tax.

(e) Training Services and Materials. Data processing firms provide a number of training services, such as data entry and verification, programming, and specialized training in systems design.

(1) Charges for training services are nontaxable, except as provided in subdivision (g) where the training services are provided as part of the sale of tangible personal property. The data processing firm is the consumer of tangible personal property which is used in training others, or provided to trainees without a separate charge as a part of the training services.

(2) Tax applies to charges for training materials, including books, furnished to trainees for a charge separate from the charge for training services.

(3) Where a person sells tangible personal property, such as computers or programs, and provides training materials to the customer without making an additional charge for the training materials, this is a sale of the training materials. The selling price of the training materials is considered to be included in the sales price of the tangible personal property.

(f) Computer Programs.

(1) Prewritten (Canned) Programs. Prewritten programs may be transferred to the customer in the form of storage media, or by listing the program instructions on coding sheets. In some cases they are usable as written; however, in other cases it is necessary that the program be modified, adapted, and tested to meet the customer's particular needs. Tax applies to the sale or lease of the storage media or coding sheets on which or into which such prewritten (canned) programs have been recorded, coded, or punched.

(A) Tax applies whether title to the storage media on which the program is recorded, coded, or punched, passes to the customer, or the program is recorded, coded, or punched on storage media furnished by the customer. The temporary transfer of possession of a program, for a consideration, for the purpose of direct use or to be recorded or punched by the customer, or by the lessor on the customer's premises, is a lease of tangible personal property. The tax applies unless the property is leased in substantially the same form as acquired by the lessor and the lessor has paid sales tax reimbursement or use tax with respect to the property.

(B) Tax applies to the entire amount charged to the customer. Where the consideration consists of license fees, all license fees, including site licensing and other end users fees, are includable in the measure of tax. Tax does not apply, however, to license fees or royalty payments that are made for the right to reproduce or copy a program to which a federal copyright attaches in order for the program to be published and distributed for a consideration to third parties, even if a tangible copy of the program is transferred concurrently with the granting of such right. Any storage media used to transmit the program is merely incidental.

(C) Maintenance contracts sold in connection with the sale or lease of a prewritten computer programs generally provide that the purchaser will be entitled to receive,

during the contract period, storage media on which ~~the~~ prewritten program improvements or error corrections have been recorded. The maintenance contracts may provide that the purchaser is entitled to receive storage media on which a backup copy of the same or similar prewritten program is recorded, so that the purchaser may use the backup copy to restore the prewritten program. The maintenance contract also may provide that the purchaser will be entitled to receive, during the contract period, telephone or on-site consultation services.

If the purchase of the maintenance contract is not optional with the purchaser, that is, if the purchaser must purchase the maintenance contract in order to purchase or lease a prewritten computer program, then the charges for the maintenance contract are taxable as part of the sale or lease of the prewritten program. Tax applies to any charge for consultation services provided in connection with a maintenance contract except as provided below.

For reporting periods commencing on or after January 1, 2003, if the purchase of the maintenance contract is optional with the purchaser, that is, if the purchaser may purchase the prewritten software without also purchasing the maintenance contract, and there is a single lump sum charge for the maintenance contract, 50 percent of the lump sum charge for the maintenance contract is for the sale of tangible personal property and tax applies to that amount; the remaining 50 percent of the lump sum charge is nontaxable charges for repair.

If no tangible personal property whatsoever is transferred to the customer during the period of the maintenance contract, tax does not apply to any portion of the charge. Tax does not apply to a separately stated charge for consultation services if the purchaser is not required to purchase those services in order to purchase or lease any tangible personal property, such as a prewritten computer program or a maintenance contract.

(D) The sale or lease of a prewritten program is not a taxable transaction if the program is transferred by remote telecommunications from the seller's place of business, to or through the purchaser's computer, and the purchaser does not obtain possession of any tangible personal property, such as storage media, in the transaction. Likewise, the sale of a prewritten program is not a taxable transaction if the program is installed by the seller on the customer's computer except when the seller transfers title to or possession of storage media or the installation of the program is a part of the sale of the computer. Paragraph (C) applies to optional software maintenance contracts sold in connection with nontaxable transactions described in this paragraph.

If the transfer of a prewritten program is a nontaxable transaction, then the seller is the consumer of tangible personal property used to produce written documentation or manuals (including documentation or manuals in machine-readable form) designed to facilitate the use of the program and transferred to the purchaser for no additional charge. If a separate charge is made for the documentation or manuals, then tax applies to the separate charge.

(E) The transfer of a prewritten program on storage media is not a sale for resale when the storage media, or an exact copy, will be used to produce additional copies of the program.

Charges for testing a prewritten program on the purchaser's computer to insure that such a program operates as required are installation charges and are nontaxable

(2) Custom Programs.

(A) Tax does not apply to the sale or lease of a custom computer program, other than a basic operational program, regardless of the form in which the program is transferred. Nor does the tax apply to the transfer of a custom program, or custom programming services performed, in connection with the sale or lease of computer equipment, whether or not the charges for the custom program or programming are separately stated.

(B) However, charges for custom modifications to prewritten program are nontaxable only if the charges for the modifications are separately stated. Otherwise, the charges are taxable as part of the sale of the prewritten program.

When the charges for modification of a prewritten program are not separately stated, tax applies to the entire charge made to the customer for the modified program unless the modification is so significant that the new program qualifies as a custom program. If the prewritten program was previously marketed, the new program will qualify as a custom program, if the price of the prewritten program was 50 percent or less of the price of the new program. If the prewritten program was not previously marketed, the new program will qualify as a custom program if the charge made to the customer for custom programming services, as evidenced in the records of the seller, is more than 50 percent of the contract price to the customer.

(C) Charges for any written documentation or manuals designed to facilitate the use of a custom computer program by the customer are nontaxable, whether separately stated or not. The vendor of the custom computer program is the consumer of the written documentation or manuals, or of any tangible personal property used by the vendor in producing the written documentation or manuals.

(D) A custom computer program includes a program prepared to the special order of a customer who will use the program to produce and sell or lease copies of the program, and the charge for such custom computer program is not subject to tax. Sales or leases of the copies, however, are taxable as sales of prewritten computer programs.

(E) A computer program prepared to the special order of a customer to operate for the first time in connection with a particular basic operating system is a custom computer program even though a different version currently operates in connection with an incompatible basic operating system.

(F) Digital pre-press instruction is a custom computer program under section 6010.9 of the Revenue and Taxation Code, the sale of which is not subject to tax, provided the digital pre-press instruction is prepared to the special order of the purchaser. Digital pre-press instruction shall not, however, be regarded as a custom computer program if it is a “canned” or prewritten computer program which is held or existing for general or repeated sale or lease, even if the digital pre-press instruction was initially developed on a custom basis or for in-house use. The sale of such canned or prewritten digital pre-press instruction in tangible form is a sale of tangible personal property, the retail sale of which is subject to tax.

(g) Service Charges. The following activities are service activities. Charges for the performance of such services are nontaxable unless the services are performed as a part of the sale of tangible personal property.

- (1) Designing and implementing computer systems (e.g., determining equipment and personnel required and how they will be utilized).
- (2) Designing storage and data retrieval systems (e.g., determining what data communications and high-speed input-output terminals are required).
- (3) Consulting services (e.g., study of all or part of a data processing system).
- (4) Feasibility studies (e.g., studies to determine what benefits would be derived if procedures were automated).
- (5) Evaluation of bids (e.g., studies to determine which manufacturer's proposal for computer equipment would be most beneficial).
- (6) Providing technical help, analysts, and programmers, usually on an hourly basis.
- (7) Training Services.
- (8) Maintenance of equipment. (See Regulation 1546 for application of tax to maintenance contracts.)
- (9) Consultation as to use of equipment.

(h) Pick-up and Delivery Charges. If the data processing firm's billing is for nontaxable processing of customer-furnished information, the tax will not apply to pick-up and delivery charges. If pick-up and delivery charges are made in conjunction with the sale of tangible personal property or the processing of customer-furnished tangible personal property, the tax will apply to the pick-up charges. Tax will apply to the delivery charges to the extent specified in regulation 1628, “Transportation Charges.”

(i) Rental of Computers. A lease includes a contract by which a person secures for a consideration the use of a computer which is not on his or her premises, if the person or his or

her employees, while on the premises where the computer is located operate the computer, or direct and control its operation. A lease does not include a contract whereby a person secures access by means of remote telecommunication to a computer which is not on his or her premises, if the person or his or her employees operate the computer or direct and control its operation by means of remote telecommunication. (See Regulation 1660 for application of tax to leases.)